Political Pressure and the Future of the Federal Reserve System*

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FROM the earliest beginning it was obvious that, in order to be successful, any attempt at a thorough banking reform in the United States would have to approach the subject from two angles: one, from the point of view of pure banking technique, the other, from the point of view of administration. The problem was to devise a plan carrying conviction not only as a sound and effective piece of banking machinery, but also as offering reliable safeguards against any possibility of the control of the system's passing into the hands of either "big business" or the politician. If legislation was to be secured and, indeed, if the future of the system was to be protected, a formula had to be found under which these two elements would be called upon to balance one another. If the new banking system was to remain safe and sound, its administration had to be shielded from the danger of becoming subservient either to business or to politics, and, conversely, safeguards had to be provided against business' or politics' becoming subservient to the new banking system.

From the bare point of view of efficiency and economy, one central bank with a purely business management would undoubtedly have yielded the best results, but from the point of view of what was required in the larger interest of the country, of what was essential in order to prevent the system, once established, from becoming the target of ambitious business men or scheming politicians, maximum efficiency had to be subordinated to maximum safety.

The writer's original plan, "A United Reserve Bank of the United States," proceeded on these lines; so did, subsequently, the Aldrich "National Reserve Association of the United States" and, later on, the Federal Reserve plan. Each of these schemes followed the lines of merging the country's dead gold reserves into one live organization; of building upon this more or less centralized gold an elastic note issue; and having thus centralized the scattered forces of the nation into one organic structure, of once more decentralizing its administration and organization, and circumscribing it far enough to prevent the dangers of abused power and of one-sided control.

The advocates of a pure central bank had to reconcile themselves to a lower banking ideal by surrendering to the political requirements of the case. Conversely, the sworn antagonists of a central banking system had to surrender their political ideal, the gospel of decentralized banking, in order to provide a system that would be workable as a banking proposition.

Thus the Democrats, starting with the thought of a large number of disconnected reserve banks, ended in tying them together into a central banking system, in its essential features not very dissimilar (though differing in many important details) from the Aldrich Plan, which had started at the other end.

Disregarding the question of which

* Adequate treatment of this subject would require more time and study than was possible under the circumstances and more space than could be given in this volume. P. M. W.

side made the largest share of valuable contributions and mistakes and, dealing with the topic simply from the point of view of sincere appreciation of the banking system which we enjoy today, the problem now before us is to examine what remains to be done in order to promote and protect its future.

A study of four years from within the System and of almost four years from without, leads me to think that its gravest danger lies in the gradual ascendency of political influence.

The Federal Reserve System, as such, is based upon the perfectly sound and happy theory of placing the actual management of the Federal Reserve Banks in the hands of boards of directors, the majority of whom are appointed by business men. The direction of the System as a whole, on the other hand, its policies and its supervision, are vested in the Federal Reserve Board, which consists of five members appointed by the President and confirmed by the Senate. These members are appointed for ten-year terms and the Governor and Vice-Governor are designated by the President and serve at his pleasure. The Secretary of the Treasury and the Comptroller of the Currency are members ex officio. The Secretary of the Treasury is Chairman of the Board.

Among the many Presidents, Secretaries of the Treasury, Senators, Congressmen and Comptrollers of the Currency that I have known, there have been good ones and bad ones, some admirably strong and some lamentably weak. And therein lies the danger for the future: As long as there are two ex-officio members of the Board, who are constantly subjected to political pressure; so long as every President has the power to play favorites with Board members by promoting them to the positions of Governor or Vice-Governor or demoting them at will; so long as one or two members may be vulnerable because their terms are about to expire, it can readily be seen how easy, and therefore tempting, it is for the political members to assert their influence, and how unpleasant and unenviable may be the lot of members struggling to preserve their independence and self-respect.

When members of the Board are hounded by senators or congressmen because they do not think it proper to flood the country with easy money, just because elections are coming; or when they refuse to believe that excessive fluctuations in foreign exchanges during the War were due to Wall Street speculation and could be regulated or controlled by the Federal Reserve Board; or when they are viciously criticised because they will not accede to the belief that fake easy money can counteract the effects of overproduction of important staples when a period of reduced world consumption is encountered—it is, at best, not easy to find men of importance willing to make the material sacrifices involved in service of the Federal Reserve Board.

It will become increasingly hopeless, however, to secure such men if some of the defects in the organization of the Board as above described are not promptly removed and the dignity and independence of the office of member are not enhanced. To state it briefly: The Governor and Vice-Governor ought to be elected by the Board itself; or they should serve in rotation, and the office of the Secretary of the Board might, in the latter case, be developed into that of something like a "general manager," or the Governor ought to be designated for the full term of his membership. The Governor ought to be the Chairman of the Board and, instead of the Secretary of the Treasury, who hardly ever has the time to attend Board meetings, the Assistant

Secretary of the Treasury ought to become an ex-offico member of the Board. There should be an additional member of the Board, who should exercise the main functions now resting in the Comptroller of the Currency. The vast powers now vested in the Comptroller are the remnants of an undemocratic, antiquated and dangerous system. Moreover, the present condition has led in the past to costly delays, duplication of work, inefficiency and unbearable irritation. Examinations and rulings concerning banking operations ought to be made by one body and not by two, if a prompt and efficient administration is to be assured. In the past, Board members often have had to wait upon the good graces—or bad graces—of the Comptroller before any headway could be made in important matters. The situation bristled with humiliating and distasteful incidents. It seems ridiculous that the Board should have appeared before Congress with one set of recommendations and the Comptroller, a Board member, with another, often entirely in conflict with the policies of the Board.

Unless the Federal Reserve Board is raised to a position of the greatest possible dignity and men of real strength, independence and knowledge are found to serve upon it in the future, it is to be feared that the System will become the football of politics. A splendid instrument of protection might thus become an element of dangerous disturbance.

This danger is all the more real because of the unfortunate action of the Organization Committee in establishing twelve Federal Reserve Banks instead of beginning with eight, as the Federal Reserve Act had permitted them to do.

The larger the number of Federal Reserve Banks and the greater the consequent decentralization, the more important becomes the Federal Reserve Board as the sole organic link connecting them all. The weaker the single districts and the more disconnected they are, the more difficult, and at times desperate, becomes the task of the Federal Reserve Board to coax or club these autonomous units into prompt and effective coöperation. The Board was planned to be preëminently a supervisory and directive body; excessive decentralization was bound to force it more and more into the exercise of administrative functions, which—for men located at Washington, unable to be in personal close touch with actual business conditions and operations in twelve separate and remote districts—naturally became more bewildering and troublesome than was advisable or necessary.

The fundamental thought of reserve banking is that the idle money of one industry or section should become available for the seasonal requirements of another. Federal Reserve Districts, therefore, which are "all cotton" or "all grain" were from the beginning doomed to fail as independent districts; seasonal requirements were bound to exhaust their loaning power too rapidly. While they could secure assistance through the somewhat clumsy procedure of rediscounting with other Federal Reserve Banks under the direction of the Federal Reserve Board, they generally would be inclined to hesitate to resort to these rediscount operations, inasmuch as they would tend to emphasize the organic weakness or temporary exhaustion of their districts. Unfortunately the Organization Committee disregarded this fundamental principle and the districts of St. Louis, for instance, and its surrounding Federal Reserve districts were delineated with about the same regard for economic questions as were Austria and her so-called Succession

States at Versailles. Owing to this absence of a sufficient diversification of interests and minds, local banking factions and self-centered provincialism have from the beginning played too large a part in framing the boards of directors, the managements and the policies of many of the twelve Federal Reserve Banks, with little understanding of the national questions involved. Much bitter feeling and criticism were caused, particularly in the agricultural sections, by unnecessary and irritating mistakes made in fixing interest charges or in applying ill-advised methods of administration. Whatever anticipatory words or warning in this regard were given to Congress and later to the Organization Committee, unfortunately, have proved only too true, including the prophecy that an excessive number of Federal Reserve Banks would prevent the establishment of large financial centers outside of New York, where important open discount markets could develop.

It is a great loss for the country that at the time of the formulation of the law and the establishment of the System it was impossible to convince the sections involved that a Federal Reserve branch bank could convey the same benefit as a Federal Reserve Bank; indeed, that as a branch of a larger district a region would be better served than as a self-contained district. Minneapolis, as a branch of Chicago, would have been as well provided for as Detroit, but it would enjoy a rate of 5 per cent instead of its present $5\frac{1}{2}$ per cent rate. The same holds good for Dallas and Atlanta.

As stated before, the weaker the Federal Reserve Banks, the stronger must be the Federal Reserve Board. This is all the more essential because the Board appoints the C class directors. The latter often constitute very important elements of safety and must be appointed, political pressure notwithstanding, solely from the point of view of securing the men best qualified for the protection of the Banks. Finally, the future of the local management of all banks, in short, the morale of the entire System, will depend upon the character of the Federal Reserve Board.

If the Federal Reserve System was able to accomplish its phenomenal development and if it could respond so splendidly to the trying demands of the war, and of the post-war periods, it was largely due to the devotion, vision and ability of members of the Federal Reserve Board and of some of the Federal Reserve agents and governors of Federal Reserve Banks, who perfected and developed the System into the extraordinary banking organization it is today. Strong and exceptional men made themselves the leaders of the rest. Without them, the System would have failed. Such men today are still serving the System, though from the material point of view many of them could do vastly better for themselves in other fields. If politics should creep into the Board, these men will gradually drop out, and from top to bottom the System will deteriorate. If the administration of the Federal Reserve System, in Washington and in the banks, should then fall into the hands of weak and incapable men who only see "fat jobs" in the positions, instead of those who today devote themselves to the work at a personal sacrifice because they see in it an opportunity for public service, there are dark days ahead for the country.

Government must exercise an effective control over business in its administration of the Federal Reserve Banks; but this control must be exerted through a Federal Reserve Board comprising men of the highest integrity and efficiency—men who do not seek the

job and would not hesitate to surrender it, if either business or politics should interfere with the independent exercise of their duties for the best advantage of the country as a whole.

If that is to be achieved, and the future of the Federal Reserve System is to be assured, the people themselves must take a hand. They must never fail to rally to the support of these faithful servants when unfairly attacked, and they must not lose any opportunity of showing them that their services are appreciated. If the people do not prove that they honor their leaders and stand by them loyally, what incentive is there for these leaders to hold out?

In a similar manner, Congress must feel that whoever dares to encroach upon the independence of the Federal Reserve System attacks the most sacred treasure of the people. In Washington I came to know many upright men of the very highest type; nevertheless a large number of our political leaders might prefer that the Federal Reserve System be subservient rather than independent. They want open doors for patronage and a ready compliance with the wishes of their constituents.

Protection for the Federal Reserve System must, therefore, not be expected from Washington, unless it is possible to arouse and strengthen the small number of distinguished men in the Administration, and in Congress, who would understand the danger and would fight to ward it off. They will win if the country makes Congress understand that its heart is in it. If the people cease to exercise vigilance, if ever they relax in their insistence upon the integrity of their banking system, it may develop, as it did before, from the greatest blessing into the gravest menace. A Federal Reserve System turned into a political octopus, a national Tammany Hall, would infest not only the counting houses but every farm and hovel in the country.

Early Functioning of the Federal Reserve System

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ON October 26, 1914, the Secretary of the Treasury sent a message to the twelve Federal Reserve Banks, then organizing, instructing them to begin definite operations on November 16, 1914. Great haste was made to secure adequate quarters and a working staff. One-sixth of the capital stock subscriptions were called on November 2, 1914, and on the sixteenth of November the Banks formally opened for business.

"Regulation in ordinary times, as well as protection in extraordinary times" was the principle laid down by the Federal Reserve Board in its first report after two months of operation, for defining the general scope of activities of the Federal Reserve Banks. There being no extraordinary times to call for the protective function as set forth in the above definition of policy, the operation of the Federal Reserve System during the first two years was confined largely to efforts, first, to "unify the banking system of the country" by seeking new members among the ranks of the state banks; second, to endeavor to regulate interest rates and equalize the demand for